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Statement on

S. 2718, "EXPORT TRADING COMPANY ACT OF 1980"

Presented to

Committee on Banking, Housing and Urban Affairs
United States Senate

by

Irvine H. Sprague, Chairman
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10:00 a.m.
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5302 Dirksen Senate Office Building

Mr. Chairman, I appreciate your invitation to discuss S. 2718, the "Export Trading Company Act of 1980." My remarks are limited to Section 105 of the bill, which provides for banking organization equity investment in export trading companies.

The stated purpose of S. 2718 is "to increase United States exports of products and services by encouraging more efficient provision of export trade services to American producers and suppliers." The bill describes export trading companies as companies principally engaged in the exportation and the facilitation of the exportation of goods and services produced in the United States.

S. 2718 has been reported from your Senate Committee on Banking, Housing and Urban Affairs, has the support of the Administration, and enjoys impressive cosponsorship in the Senate. Within this context of momentum, I am grateful for the opportunity to expand on the concerns over Section 105 which I expressed in writing to the Committee on June 23, and to suggest certain amendments.

We recognize the importance of S. 2718's objective of strengthening the export of United States products and services by encouraging the improvement of export trade services to American producers and suppliers. From our perspective, however, we have questions about the degree and type of bank involvement.

In my June 23 letter, I described the general concerns we have about banking organizations taking any equity position in export trading companies. We recognize, of course, that there are times when compelling national interest requires a change in traditional practices and we should not be forever bound to the past. This may be such a case.

However, we continue to have reservations about those provisions of the bill which would allow a banking organization to acquire ownership control of an export trading company, an innovation that would represent a substantial departure from the long-established separation of banking and commerce in our economic system and could very well have safety and soundness implications.

It is important to recognize that, notwithstanding the priorities which direct us toward altering the environment of banking, such changes are not made without consequence. You have heard other points of view expressing the benefits to be realized by the legislation. It is our responsibility as insurer of the public's deposits to express to you our perception of the potential of added risk to the United States banking system and to highlight the fact that this represents historically significant incursion of banking into the province of commerce.

The concerns I have mentioned have been expressed to you by other bank regulators. Moreover, reservations about the "significant departure in the manner in which our financing institutions have traditionally operated" were expressed by several members of your Committee in its report.

We recognize and applaud the fact that your Committee has made a substantial effort to include safeguards in the legislation in an attempt to meet the supervisory concerns expressed by the Federal Reserve, the Comptroller of the Currency and the FDIC. These safeguards are outlined in detail in a June 18 letter I received from Senator Stevenson. These measures would limit the risk to our banking system, but they would not eliminate it, nor would they overcome the basic conflict inherent in the commingling of banking and commerce.

We, therefore, urge your Committee to move with caution into this new field of banking investment. If you proceed, we suggest that you allow something less than a controlling interest by banking organizations in export trading companies. This would give the banking institutions and the bank regulators time to develop experience and expertise and permit us all to address the question of control from a more knowledgeable position at a later date.

PROVISIONS OF S. 2718

As reported, the bill would allow banks, Edge Act and Agreement Corporations, and bank holding companies — collectively referred to as "banking organizations" — to invest up to $10 million in one or more export trading companies without regulatory approval if the investment does not amount to control. Proposed investments exceeding the dollar limit or amounting to control would require prior approval of the appropriate Federal regulatory agency.

Our particular concern with this portion of the bill is that it would allow banks to acquire control of export trading companies. If a bank's investment in a company is limited to a 20 percent share, and the bank does not manage the company's operations, there would be substantially less likelihood that a bank would feel legal, business or moral obligations to divert substantial resources to the trading company should it encounter serious financial difficulties.

In reviewing proposals for investment in excess of the discretionary limits, the agency must consider the financial and managerial resources, the competitive situation, and the future prospects of the banking organization and the export trading company concerned. Additionally, however, it must take into account the benefits of the proposal to U.S. business, industrial and agricultural concerns, and the improvement the proposal would bring to the U.S. competitive position in world markets.

We have historically made our decisions about banking practice strictly on the basis of our responsibility for maintaining a safe and sound banking system. S. 2718 would, to a degree, require that we modify our thinking and recognize trade-offs between safe and sound banking and other priorities. No other legislation has ever, to my knowledge, placed us in this position.

S. 2718 also provides that:

. Approval of investment in the trading companies would be denied if the agency finds the probable benefits outweighed by any adverse financial, managerial, competitive or other banking factors, implying that risk is weighed, not on its own characteristics, but in relation to the benefit to be realized by the economy. The agency also may impose conditions it feels will limit a banking organization's financial exposure to an export trading company, or which will prevent conflicts of interest or unsafe or unsound banking practices.

. A limit of up to five percent of a banking organization's consolidated surplus and capital is set for aggregate investment in export trading companies. The limit for Edge Act and Agreement Corporations not engaged in banking is 25 percent. The bill also prohibits the total of a banking organization's historical cost of the direct and indirect investment in and loans to export trading companies from exceeding 10 percent of the organization's capital and surplus.

. Agencies will set standards for the taking of title to goods by any export trading company subsidiary of a banking organization. Advance approval would be required before changes could be made in a trading company's practices in taking title to goods.

S. 2718 would impose the following additional restrictions:

1. The trading company's name may not be similar in any way to that of the investing banking organization.

2. A banking organization may not make loans to any export trading company in which it holds any interest, or to any customers of the company, on terms more favorable than those afforded similar borrowers in similar circumstances, or involving more than normal risks of repayment or displaying other unfavorable features.

3. Banking organizations cannot own any interest in an export trading company which takes positions in commodities or commodities contracts other than as may be necessary in the course of its business operations.

The bill empowers the supervisory agency to order termination of a banking organization's investment in an export trading company whenever: ". . . it has reasonable cause to believe the ownership or control of any investment in an export trading company constitutes a serious risk to the financial safety, soundness, or stability of the banking organization and is inconsistent with sound banking principles or with the purposes of this Act or with the Financial Institutions Supervisory Act of 1966."

In any such case, the bank organization has a right to notice and hearing and ultimate appeal to the courts.

Against this background, I would now like to discuss the concerns I mentioned earlier.

RISKS ASSOCIATED WITH CONTROL

Advocates of bank investment in export trading companies point to the expertise in foreign trade the banks could bring to such companies. We are not convinced that banks -- other than a few money center or major regional banks -- have any particular expertise in foreign markets.

Under the proposed bill, banking organizations would be allowed to acquire control of export trading companies which could engage in a virtually unlimited range of activities and assume commercial risks unsuited to banks. For example, under the bill, the companies could own and deal in commodities, and could acquire shipping companies and warehouses. There is potentially a high degree of risk associated with these and other activities in which export trading companies may engage.

A bank controlling a foundering trading company may incur legal liability if, for example, the bank provides management or engages in significant intercompany transactions.

Perhaps of greater importance than the legal considerations, a bank might be under considerable pressure to come to the aid of a troubled export trading company it has sponsored. History offers many examples of banks and other companies that have come to the aid of troubled subsidiaries in order to protect the parent company's reputation in the business community.

Recent experiences in connection with bank-sponsored Real Estate Investment Trusts (REITs) are illustrative of the legal and practical business obligations banks feel toward undertakings they sponsor. Some banks provided assistance due to legal considerations stemming from interlocking officers and directors and the provision of advisory services. Others came to the aid of the sponsored REITs because they believed failure to do so would severely damage their bank's reputation in its community and in business and financial circles generally.

Whatever the motivation for the assistance, the exposure may be substantially greater than the bank's equity investment due to leveraging and the potential for off-balance sheet losses.

SEPARATION OF BANKING AND COMMERCE

The separation of banking and commerce has served us well throughout our history. This separation was and is occasioned by concern for the safety and soundness of banks, fear of undue concentration of economic power, the necessity of preventing unfair competition, and the desire to guard against possible conflicts of interest between a bank's responsibility to its depositors and its own economic interests arising from ownership of nonbanking firms.

These concerns were articulated in a House Report on the 1956 amendments to the Bank Holding Company Act dealing with the divestiture of nonbanking

business by bank holding companies (H.R. Report No. 609, 84th Congress, 1st Session 16 (1955)). The Report warned of the danger to depositors that might result where the bank finds itself in effect both the borrower and the lender.

The Report continued:

> "Whenever a holding company thus controls both banks and nonbanking business, it is apparent that the holding company's nonbanking business may thereby occupy a preferred position over that of its competitors in obtaining bank credit. It is also apparent that in critical times the holding company which operates nonbanking businesses may be subjected to strong temptation to cause the banks which it controls to make loans to its nonbanking affiliates even though such loans may not at that time be entirely justified in the light of current banking standards. In either situation the public interest becomes directly involved."

These considerations appear to us to be applicable as well to the relationships that would exist under S. 2718 between banks and export trading companies.

We are concerned that the protective measures built into S. 2718 might not be sufficient to prevent abusive practices. For example, if a bank were to make credit available to an affiliated company but not to a similary situated non-affiliated company, it might not be in violation of the bill's preferential lending restrictions. In short, the restriction only applies to credit extensions on more favorable terms, and not to credit availability. The FDIC believes the potential for conflicts of this type must be minimized.

PREEMPTION OF STATE AUTHORITY

Section 105(b)(1) of S. 2718 provides for the investment in voting stock or other evidence of ownership of one or more export trading companies by any banking organization "Notwithstanding any prohibition, restriction, limitation, condition or requirement of any other law . . . ." The effect of this language is to preempt those State banking laws which prescribe the powers of the banks chartered under those laws.

Although Federal law has in the past provided restrictions on investments by State banks, such as those imposed on investments in affiliates prescribed by Section 23A of the Federal Reserve Act and Section 18(j) of the Federal Deposit Insurance Act, it is a fundamentally different matter to expand the investment powers of State banks beyond the powers granted them by the laws under which they are incorporated.

FDIC suggests that Section 105(b)(1) be revised to provide that the bill not preempt applicable State laws governing investment powers of banks. This would conform to the policy adopted by the Congress in legislation pertaining to banking investment in Edge Corporations and Small Business Investment Companies.

PRESSURE ON CAPITAL RATIOS

S. 2718 recognizes that permitting investment by banks in export trading companies poses safety and soundness questions, and it would limit the size of such investments both in terms of the total dollar amount and as a percentage of capital. Nonetheless, the risk exposure of banking organizations undoubtedly would increase if they are granted such investment powers.

This potential is greatest for the largest institutions — the regional and money center banks — which are the most likely to engage in this kind of investment activity. As we reported to the Committee in our testimony of May 21, 1980, on the condition of the banking system, the ratio of equity capital to total assets among the Nation's 300 largest banks declined in 1979 for the third straight year. The ratio for banks having assets of $5 billion or more declined last year to 4.0 percent, compared to a ratio more than twice as great for our smallest banks. Moreover, with the substantially increased loan volume produced by a growing economy, risks supported by these declining ratios have increased considerably over the past two decades.

Investments in export trading companies could represent riskier assets than most of the loans and investments comprising bank asset portfolios. Such investments would necessarily mean that a banking organization's equity base would have to support a greater degree of overall risk.

Your Committee recognized the capital problem and devoted 25 lines on page 11 of your Report to this issue, concluding it did not represent a serious problem, since you project only $1 billion in total bank investments and loans over the initial five year period.

Our conclusion was different. Although the incremental erosion in capital ratios for the largest institutions would be modest, we can't be happy about any development which would exacerbate their declining ratios.

ADDITIONAL AMENDMENTS

As I noted, Section 105 would authorize banking organizations to control export trading companies, subject to the approval of the appropriate Federal banking agency. Recognizing a need for caution, we support the recommendations of Chairman Volcker of the Federal Reserve, who wrote on May 12, 1980, that "it would not be prudent to permit banking organizations to exercise control over export trading companies at this time." We strongly urge that Section 105 be amended to include a provision that no banking organization, alone or in concert with its affiliates, be permitted to acquire more than 20 percent of the voting stock of an export trading company or to control the company in any other way, and that not more than 50 percent of an export trading company's voting stock be owned by any group of banking organizations.

The rationale for these recommendations is to give the banking industry and the bank regulators an opportunity to gain experience and develop a measurable track record before a final determination is made as to whether

banking organizations should be permitted to control export trading companies. During this period, banking organizations also could test the expanded export trade services offered by last year's amendments to the Edge Corporation rules and the Federal Reserve could consider additional liberalizations in this area.

Governor Wallich in his statement of April 3, 1980, described existing export services through Edge Corporations as encompassing a full range of financing services, foreign exchange facilities, information on foreign markets and economies, introductions, business references, and advice on arranging shipments. Amendments to the Edge Corporation rules effective June 14, 1979, expanded the finance capabilities of Edge Corporations in the international export trade area and permitted them to branch domestically, thus potentially increasing access to their services.

— We urge that the bill be amended to require that any investment by a banking organization in an export trading company, regardless of amount, be subject to prior approval by the appropriate Federal banking agency.

-- Section 103(a)(5) of the bill defines an export trading company as a company organized and operated "principally" to export U.S. goods and services and to facilitate their exportation by unaffiliated persons. Notwithstanding the discussion of this point in the Senate Committee Report, the word "principally" is somewhat ambiguous and provides an avenue for export trading companies to become significantly engaged in activities or operations that are not at all related to the conduct of an export trading company.

To the extent that trading companies are permitted to engage in unrelated activities, the purpose of the bill could be defeated and the risk of loss increased. We believe that the definition of export trading company should be more clearly defined and made more restrictive. We suggest that the definition limit the operation and activities of such companies to the business of exporting U.S. goods and services and the facilitation of their export by unaffiliated persons, and to activities so closely related to that business as to be a proper incident thereto.

— We are also concerned that the definition of "capital and surplus" in Section 105(a)(10) could be interpreted to include subordinated notes and debentures. We suggest that the bill or its legislative history make clear that this is not the case.

— Sections 105(b)(2) and (3) would require the appropriate banking agency to act within 60 days on written notice by banking organizations of their intentions to make additional investments or to undertake certain activities by export trading companies and to act within 90 days of notice by a banking organization of its intent to make a $10 million investment or any controlling investment in an export trading company. If the agency fails to act within the time limits, the application would be deemed approved. If our recommendations on control and prior approval of all investments are not accepted, we recommend that — in both instances —

the statutory limit be extended to 120 days or that the agency be authorized to make appropriate extensions, provided that the total waiting period does not exceed 120 days.

— Section 105(c)(3) precludes export trading companies from taking positions in commodities or commodity contracts "other than as may be necessary in the course of its business operations." The intent is to prevent speculation in commodities. We believe the section should be amended to preclude speculation in foreign exchange and securities as well.

-- Section 105(d)(2) gives Federal banking agencies 270 days after enactment to establish standards for taking title to goods and holding inventory to prevent unsafe and unsound practices. In view of the newness and complexity of the issue, we believe 270 days is insufficient and recommend the time limit be at least one year.

CONCLUSION

We appreciate the opportunity to comment on this bill. Should you be inclined to accept any of our suggestions we would be glad to provide drafting assistance by our staff.

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